In the

United States Circuit Court of Appeals

For the Ninth Circuit

Docket No. 5710

WALVILLE LUMBER COMPANY,
a corporation,
Appellant and Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Brief for the Appellant and Petitioner

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INTRODUCTION

This is a petition by the WALVILLE LUMBER COMPANY for Review by the United States Circuit Court of Appeals of a decision of the United States Board of Tax Appeals promulgated and filed under date of May 28, 1928, and for review of an Order of Redetermination made, entered and filed by the Board on May 31, 1928. This Petition

for Review is filed in pursuance of the provisions of Section 1001 of the Act of Congress approved February 26, 1926, entitled "The Revenue Act of 1926."

The proceeding before the United States Board of Tax Appeals resulted from the determination by the respondent, Commissioner of Internal Revenue, of a deficiency of $7,514.86 in petitioner's income and profits taxes for the year 1919. The deficiency arises from the refusal of the respondent to allow a deduction claimed by the petitioner as a loss sustained by it on 4,400 shares of stock of the WALWORTH & NEVILLE MANUFACTURING COMPANY purchased and paid for by petitioner in 1908 and which had become worthless within the year 1919.

The petitioner relied upon the following assignment of error before the Board:

> "The Commissioner of Internal Revenue erred in disallowing the loss sustained with respect to an investment in shares of stock of the WALWORTH & NEVILLE MANUFACTURING COMPANY acquired in the year 1908 at a cost of $440,000.00, with a value at the basic date of March 1, 1913, of $225,967.28 as determined by the Bureau of Internal Revenue, said loss representing such fair value in excess of the amount received therefor upon the dissolution of the issuing company."

STATEMENT OF FACTS

The WALVILLE LUMBER COMPANY, hereinafter sometimes also referred to as the "Lumber Company," was incorporated in the year 1908, under the laws of the State of Washington, with an authorized capital stock of $1,000,000.00, consisting of 10,000 shares of the par value of $100.00 each.

In the same year the petitioner acquired from the WALWORTH & NEVILLE MANUFACTURING COMPANY, a Michigan corporation, hereinafter sometimes also referred to as the "Manufacturing Company," certain timber-lands, cut-over lands, sawmill, cross-arm factory, machinery and equipment and 4,400 shares of the common stock of the said Manufacturing Company and issued therefore to various individuals its entire authorized capital stock. The value of all of this property at the date of acquisition by the petitioner was $1,170,329.46, so that the petitioner had a paid-in surplus of $170,329.46.

The 4,400 shares of stock acquired from the said Manufacturing Company as above set forth and owned by the petitioner on March 1, 1913, had a fair market value on that date of $225,967.28.

The stock of the WALWORTH & NEVILLE MANUFACTURING COMPANY consisted of 8,000 shares of common stock and 1,000 shares of preferred stock, all of the par value of $100.00 per

share. In the year 1919, the petitioner owned 4,400 shares of the common stock of the Manufacturing Company, but at no time owned any part of the preferred stock.

In the year 1919, the Manufacturing Company owned 5,541 shares of the stock of the petitioner.

In 1919, the petitioner reduced its capital stock *without consideration* to 2,500 shares of common stock and 2,500 shares of preferred stock; all of the par value of $100.00 each. This procedure reduced the 5,541 shares of the petitioner's stock then owned by the Manufacturing Company to 1385¼ shares of common and 1385¼ shares of preferred. In the distribution of its reduced stock, the petitioner issued 1385¼ shares of preferred stock to certain owners of the preferred stock of the Manufacturing Company; 629¼ shares of common stock to other stockholders of the Manufacturing Company; 1,-114¾ shares of preferred stock, and 1,114¾shares of common stock to its stockholders other than the Manufacturing Company; and retained unissued 756 shares of common stock.

Summarizing the issuance of said stock we have:

PREFERRED STOCK OF WALVILLE LUMBER COMPANY AFTER RECAPITALIZATION

	1,385¼	shares of preferred stock issued to owners of preferred stock of WALWORTH & NEVILLE MANUFACTURING COMPANY.
	1,114¾	shares of preferred stock issued to stockholders of WALVILLE LUMBER COMPANY other than the WALWORTH & NEVILLE MANUFACTURING COMPANY.
TOTAL	2,500	shares of preferred stock being entire issue of WALVILLE LUMBER COMPANY preferred stock after recapitalization.

COMMON STOCK OF WALVILLE LUMBER COMPANY AFTER RECAPITALIZATION

629¼	shares issued to common stockholders of WALWORTH & NEVILLE MANUFACTURING COMPANY, other than the WALVILLE LUMBER COMPANY.
1,114¾	shares issued to stockholders of WALVILLE LUMBER COMPANY other than WALWORTH & NEVILLE MANUFACTURING COMPANY.
756	shares unissued and remaining with WALVILLE LUMBER COMPANY, and being the proportion which its 4,400 shares of common stock investment in WALWORTH & NEVILLE MANUFACTURING COMPANY apparently entitled it to.
TOTAL 2,500	shares of common stock being entire issue of WALVILLE LUMBER COMPANY common stock after recapitalization.

As stated above, the WALWORTH & NEVILLE MANUFACTURING COMPANY was entitled, after recapitalization, to 1,385¼ shares of common and 1,385¼ shares of preferred of WALVILLE LUMBER COMPANY stock. Instead of receiving direct the 1,385¼ shares of preferred stock, the same was issued to the preferred stockholders of the Manufacturing Company, so that portion of the Lumber Company's obligation was discharged.

As regards the 1,385¼ shares of common stock to which the Manufacturing Company was entitled, this obligation was discharged in the following manner:

629¼	shares of common issued to stockholders of WALWORTH & NEVILLE MANUFACTURING COMPANY other than the WALVILLE LUMBER COMPANY.
756	shares of common remaining unissued with the WALVILLE LUMBER COMPANY and being the proportion which its 4,400 shares of common stock in WALWORTH & NEVILLE MANUFACTURING COMPANY apparently entitled it to.
TOTAL 1,385¼	shares of common stock in WALVILLE LUMBER COMPANY to which WALWORTH & NEVILLE MANUFACTURING COMPANY or its stockholders were entitled to after the recapitalization.

Upon the completion of the recapitalization of the petitioner, the Manufacturing Company had no assets and was dissolved with its outstanding stock of the par value of $440,000.00 owned by the WALVILLE LUMBER COMPANY. It was also in debt to its own preferred stockholders in amounts not disclosed by the records.

In its income and profits tax return for the year 1919, the petitioner estimated the value at March 1, 1913, of its 4,400 shares of the common stock of the Manufacturing Company at $150,000.00 and deducted as a loss sustained in the taxable year the difference between such value and the par value of its 756 shares of unissued stock, or a loss in the amount of $74,400.00. The respondent disallowed the deduction so claimed and determined the deficiency here in controversy.

The parties agree that the stock of the WALWORTH & NEVILLE MANUFACTURING COMPANY owned by the petitioner were acquired at a cost of $440,000.00 and had a fair market value of $225,967.28 at March 1, 1913, and that the 756 shares of the unissued stock of the petitioner in the taxable year 1919 had a fair market value of $107,-197.53. Therefore, if the Court should decide that the petitioner is entitled to deduct the loss claimed, the amount of such deduction is $118,769.75.

The testimony at the hearing conclusively showed that the 756 shares of stock of the WALVILLE LUMBER COMPANY which remained unissued after the reduction of the capital stock of the WALVILLE LUMBER COMPANY, was the proportionate amount of WALVILLE LUMBER COMPANY stock which its holdings in the WALWORTH & NEVILLE MANUFACTURING COMPANY would have entitled it to receive on the distribution of the assets of the latter company if the said 756 shares of common stock had actually been issued, and a dissolution had at that time. (Testimony of JOHN H. NEVILLE, both direct and cross-examination hereinafter quoted and referred to.)

The Board rendered its Findings of Fact, together with an opinion on May 28, 1928, in which the Board held that the petitioner sustained no deductible loss in the year 1919 with respect to its investment in the 4,400 shares of stock of the WALWORTH & NEVILLE MANUFACTURING COMPANY.

Thereafter on May 31, 1928, the Board entered its final Order of Redetermination ordering and deciding that there was a deficiency in tax for the year 1919 in the sum of $7,514.86.

Thereafter, the petitioner feeling itself aggrieved by the Findings of Fact, opinion, decision

and Order of Redetermination presented its Petition for Review before this Court.

ASSIGNMENTS OF ERROR SEPARATELY STATED AND NUMBERED IN RESPECT OF EACH AND EVERY ERROR ASSERTED AND INTENDED TO BE ARGUED

The decision, order and judgment made and entered by the United States Board of Tax Appeals in the above entitled cause on May 31, 1928, in favor of the respondent, Commissioner of Internal Revenue, and against the petitioner, WALVILLE LUMBER COMPANY, is erroneous and against the just rights of the said petitioner, and as a basis for review of said decision, order and judgment, petitioner makes the following assignments of error which said petitioner avers occurred upon the hearing of said cause and upon which assignments of error the petitioner relies as a basis of this proceeding:

I.

The Board erred in entering the Order of Redetermination made and entered on May 31, 1928, and in finding and deciding that there is a deficiency for the year 1919 in the amount of $7,514.86 or in any amount.

II.

The Board erred in finding as a fact that upon the completion of the recapitalization of the pe-

titioner, WALVILLE LUMBER COMPANY, the WALWORTH & NEVILLE MANUFACTURING COMPANY had as assets an interest in the stock of the petitioner, there being no evidence in the record to support any such finding and there being no competent evidence offered or received at the hearing to prove the allegations of said finding of fact and said allegations of said finding of fact were and are against the preponderance of the evidence.

III.

The Board erred in its conclusion in its decision and opinion promulgated under date of May 28, 1928, to the effect that if the petitioner had issued to the WALWORTH & NEVILLE MANUFACTURING COMPANY the 1,385¼ shares of preferred stock and the 1,385¼ shares of common stock of the petitioner to which the Manufacturing Company was entitled, and if, after such issue, the WALWORTH & NEVILLE MANUFACTURING COMPANY had distributed such issue as a liquidating dividend, the petitioner, as the owner of 4,400 of the 9,000 outstanding shares of stock of the WALWORTH & NEVILLE MANUFACTURING COMPANY would have received back 1,354¼ shares of its own stock and other owners of the stock of the WALWORTH & NEVILLE MANUFACTURING COMPANY would have received the remainder or 1,416 shares, there being no evidence

in the record to support any such finding and there being no competent evidence offered or received at the hearing to prove the allegations of said finding of fact and conclusion and said allegations of said finding of fact and conclusion were and are against the preponderance of the evidence and the said conclusion and the whole thereof is not supported by the findings of fact or the evidence herein.

IV.

The Board erred in failing and refusing to find and adopt petitioner's requested finding of fact Number One.

V.

The Board erred in failing and refusing to find and adopt petitioner's requested finding of fact Number Two.

VI.

The Board erred in failing and refusing to find and adopt petitioner's requested finding of fact Number Five.

VII.

The Board erred in failing and refusing to find and adopt petitioner's requested finding of fact Number Six.

VIII.

The Board erred in its conclusion that the petitioner sustained no loss in the year 1919 with respect to its investment in the 4,400 shares of stock of the WALWORTH & NEVILLE MANUFACTURING COMPANY which were purchased and paid for by the petitioner in 1908 and which had become worthless within the year 1919.

IX.

The Board erred in entering the Order of Redetermination made and entered on May 31, 1928, for the reason that the same is not supported by the findings of fact herein nor by any evidence herein.

X.

The Board erred in failing and refusing to enter an order in favor of the petitioner ordering and deciding that there was and is no deficiency in income and profits taxes for the year 1919.

THE ISSUE

The only question is whether the petitioner, WALVILLE LUMBER COMPANY, sustained a deductible loss in the year 1919 with respect to its investment in the 4,400 shares of stock of the WALWORTH & NEVILLE MANUFACTURING COMPANY which was dissolved during such year. The petitioner claims a deductible loss measured by

the difference between the fair market value of the 4,400 shares as of March 1, 1913, in the sum of $225,967.28 and the value of its 756 unissued shares in 1919 in the sum of $107,197.53, or a loss of $118,-769.75.

ARGUMENT

POINT I. At the very most, petitioner received as a liquidating dividend on its 4,400 share investment in the WALWORTH & NEVILLE MANUFACTURING COMPANY, the sum of $107,197.53, which represents the admitted value of its 756 unissued shares, which was its *pro rata* allowance on its 4,400 share investment in the WALWORTH & NEVILLE MANUFACTURING COMPANY and using as a basis the admitted fair market value thereof of $225,967.28 as of March 1, 1913, the petitioner sustained a deductible loss in 1919 in the sum of $118,769.75.

POINT II. The petitioner did not buy or sell its own capital stock, so as to come within the "capital transaction" rule hereinafter referred to.

These points being closely related, will be considered together.

That the 4,400 shares of stock of the WALWORTH & NEVILLE MANUFACTURING COMPANY, hereinafter sometimes also referred to as the "Manufacturing Company," were acquired prior to March 1, 1913, at a cost of $440,000.00, and had a fair market value at the basic date mentioned

of $225,967.28, is admitted by the respondent, as is the fact also that the Manufacturing Company was dissolved during the taxable year 1919. The record discloses that the authorized and outstanding capital stock of the petitioner was reduced in the year 1919 *without consideration* from $1,000,000.00 to $500,-000.00, consisting in equal amounts of common and preferred stock and that all of the preferred stock was issued, and only 1,744 shares of the common was issued, thus leaving 756 shares of the common of the par value of $75,600.00 at all times unissued.

At the very outset, we might point out that the respondent will undoubtedly contend that the transaction, which took place in 1919, was what the Treasury Department terms "a capital transaction" —that is, either the purchase or sale by a corporation of its own capital stock. The Treasury Department has by regulation provided that a corporation realizes no gain or loss from the purchase or sale of its own stock. We are not here concerned as to whether or not the said regulation is valid.

We might point out to the Court that the respondent, Commissioner of Internal Revenue, has apparently not questioned the fact that the petitioner sustained a loss in the year 1919 with respect to its 4,400 share investment in the common stock of the WALWORTH & NEVILLE MANUFACTURING COMPANY, but apparently has con-

tended that said loss is not deductible on the theory that the same was a "capital transaction." This is the only ground upon which the Commissioner disallowed the loss. The denial by the Commissioner of petitioner's claim in abatement from which the appeal in this case was taken to the United States Board of Tax Appeals, states under "Explanation of Adjustments to Net Income" for the year 1919, in Paragraph (b) thereof, the following:

> "Loss claimed on WALWORTH & NEVILLE MANUFACTURING COMPANY stock is not allowed as a deduction from income since same is considered a capital account. (See Article 862, Regulations 45. Office decision 479; Cumulative Bulletin III-2.)" (Transcript of record, p. 17.)

As an addition to net income as a part of said statement appears under (b) "Losses on W. & N. Mfg. Co., $74,400.00." (Transcript of Record, p. 15.)

It will thus be seen that the Commissioner's only ground for disallowing the loss claimed in the income tax return, was that the same constituted a "capital transaction." *Article 862 of Regulations 45,* reads as follows:

> "Where a corporation either directly or indirectly, as for example through a trustee, has prior to the taxable year bought its own stock, either for the purpose of retirement or of holding it in the treasury or for other pur-

poses, the entire cost of such stock must be deducted from the aggregate invested capital as of the beginning of the taxable year, if such deduction has not already been made. Where such stock is purchased during the taxable year, a deduction from the invested capital as of the beginning of the taxable year and effective from the date of such purchase is required only to the extent that such stock has not been purchased out of the undivided profits of the taxable year. The full amount derived in cash or its equivalent from the resale of such stock may be included in the invested capital from the date of such resale, unless such stock had been purchased out of earnings of the taxable year."

Office decision 479 upon which the Commissioner based his ruling that the instant case was a capital transaction, appears in Cumulative Bulletin No. 2, Jan.-June 1920, Income Tax Rulings of the Treasury Department, Bureau of Internal Revenue, at page 29, thereof, and reads in full as follows:

"A corporation issued additional shares of stock equal to approximately 7 per cent of the amount previously outstanding, using the proceeds from the sale of the stock to purchase an additional plant which, however, was later abandoned as a manufacturing plant and sold. The proceeds of this sale were used to purchase equipment for carrying out Government contracts during the war. Upon the completion of the contracts the corporation had more funds than were needed in its business and retired approximately twice the amount of additional stock previously issued, paying for each share an amount in excess of its par value. The

amount representing the par value of the stock was charged to capital account, and the amount paid in excess of its par value was charged to surplus accumulated prior to March 1, 1913. After the distribution, the corporation had no greater surplus than was reasonably required for the needs of its business.

"Held, that the distribution was not a dividend within the meaning of Section 201 (a) and (b) of the Revenue Act of 1918, but was a distribution in part liquidation of the corporation within the meaning of Section 201 (c) of the Act.

"The transaction should be treated as *a voluntary purchase* by the corporation of its capital stock for the purpose of its retirement, and the entire cost of such stock is a required deduction from invested capital of the company as of the beginning of the taxable year and effective from the date of purchase only to the extent that such stock has not been purchased out of the *undivided profits* of the taxable year.

"The stockholders who sold their stock to the company should return as income, subject to both the normal and additional taxes, any excess over and above the cost of the stock to them, or its fair market value as of March 1, 1913, if acquired prior thereto."

This same argument was urged by the respondent before the Board of Tax Appeals. The respondent's answer before the Board set up the following so-called "Propositions of Law" which respondent contended to be the law. (Transcript of Record, p. 27.)

"(1) Where a corporation exchanged shares of its own stock for shares of stock in another corporation and later upon liquidation of the other corporation received back a portion of its shares of stock, the resulting loss on the transaction is not deductible from the taxpayer's gross income but affects only its invested capital.

"(2) Where a corporation buys its own stock the entire cost of such stock must be deducted from its invested capital."

However, upon reading the Board's decision, one can find no mention of this theory. On the contrary, the Board proceeded on assumptions as to matters not in the record (and in fact the assumptions are contrary to the record) and disposed of the case on these assumptions.

The Board in deciding the case said—(Transcript of Record, pages 34 and 35):

"After reorganization the petitioner's stock consisted of 2,500 shares of preferred and 2,500 shares of common, of which 1,385¼ shares of preferred and an equal number of shares of common should have been issued to the manufacturing company, which was the owner of 55.41 per cent of the petitioner's original 10,000 shares of issued capital stock. If, after such issue, the manufacturing company had distributed the stock so received as a liquidating dividend, the petitioner, as the owner of 4,400 of the 9,000 outstanding shares of stock of the manufacturing company, would have received back 1,354¼ shares of its own stock, and other owners of the stock of the manufacturing com-

pany would have received the remainder, or 1,416 shares. Probably on account of its obligations to its preferred stockholders the manufacturing company distributed, or consented to distribution directly to its stockholders, 1,385¼ shares of the preferred and 629¼ shares of the common stock, which were due it from the petitioner after reorganization. The effect of this procedure was that the petitioner received no part of the 1,354 shares of its stock due as a liquidating dividend from the manufacturing company and received no advantage therefrom measurable in stock other than the retention of 756 shares of its new common stock unissued.

"Since each of the two companies here involved owned a controlling interest in the common stock of the other when the procedure above described was decided upon, we may assume that all the steps taken were the acts of the two corporations with the knowledge and consent of the stockholders of each. Obviously the petitioner must have agreed to relinquish a part of the liquidating dividend due it upon the dissolution of the manufacturing company in favor of the preferred stockholders of that concern. Whether the extra stock received by such preferred stockholders was a gift to them, a liquidating dividend from the manufacturing company, or a stock dividend distributed by the petitioner, cannot be determined from the meager record before us and in our opinion is not material. In any event, the petitioner has proved no loss deductible from its income in the taxable year for tax purposes."

It will thus be seen that the Board lavishly indulged in the assumption that if the WALWORTH & NEVILLE MANUFACTURING COMPANY

had received its proportion of WALVILLE LUMBER COMPANY stock upon the recapitalization in 1919, and if thereafter the WALWORTH & NEVILLE MANUFACTURING COMPANY had distributed the stock so received as a liquidating dividend, the WALVILLE LUMBER COMPANY would have received 1,354¼ shares of its own stock instead of the 756 shares which had remained unissued.

In indulging in this assumption the Board entirely overlooked the evidence in the case. JOHN H. NEVILLE, the President and General Manager of the WALVILLE LUMBER COMPANY, testified on direct examination as follows:

> "The 756 shares of common stock which were never issued by the WALVILLE LUMBER COMPANY, was the amount of stock which the WALVILLE LUMBER COMPANY would have received if it had issued to the WALWORTH & NEVILLE MANUFACTURING COMPANY all of the stock that was due that company and then a liquidation of that company had taken place. In other words the 756 shares of the WALVILLE LUMBER COMPANY stock, which were never issued, after the reduction of the capital stock of the WALVILLE LUMBER COMPANY, was the proportionate amount of the WALVILLE LUMBER COMPANY'S stock which its holdings in the WALWORTH & NEVILLE MANUFACTURING COMPANY would have entitled it to receive on the disposition of the assets of that corporation." (Transcript of Record, page 66.)

On cross examination he testified as follows:

> "The 756 shares of the common stock of the WALVILLE LUMBER COMPANY, which were not issued in 1919, represented the Lumber Company's proportion of the assets of the WALWORTH & NEVILLE MANUFACTURING COMPANY on dissolution. The reason why it was not issued was that it seemed like the better thing for the WALVILLE LUMBER COMPANY to do, to have the 756 shares as unissued stock rather than treasury stock. There was no point in issuing the stock and it gave the Lumber Company the advantage of keeping it as unissued stock." (Transcript of Record, pages 67 and 68.)

The respondent evidently was satisfied with this evidence and with this explanation for he proceeded no further with his cross examination along this line and apparently was content to agree with the petitioner that the WALVILLE LUMBER COMPANY had received all that it was entitled to receive, if a formal dissolution and liquidation of the WALWORTH & NEVILLE MANUFACTURING COMPANY had taken place at the time of the recapitalization of the WALVILLE LUMBER COMPANY.

The above is the only evidence in this case on the point, which point the Board saw fit to assume contrary to the evidence and we submit the fact is that the 756 shares of the WALVILLE LUMBER COMPANY stock which remained unissued in 1919 was the exact proportion of the liquidating dividend

in the WALWORTH & NEVILLE MANUFACTURING COMPANY which the WALVILLE LUMBER COMPANY was entitled to receive, and that said unissued 756 shares was the full amount that the Lumber Company received on account of its 4,400 share investment in the WALWORTH & NEVILLE MANUFACTURING COMPANY.

We *desire the Court to bear in mind that the WALVILLE LUMBER COMPANY is not claiming a loss on either the sale or purchase of its own capital stock, but is claiming a loss on its investment in 4,400 shares of stock in the WALWORTH & NEVILLE MANUFACTURING COMPANY. Therefore, the "capital transaction" rule of the Treasury Department, even though valid, does not apply to this case.*

In the instant case, there was no sale or exchange of petitioner's stock. On the contrary the petitioner acquired the unissued 756 shares of its own capital stock by operation of law upon the dissolution and liquidation of the WALWORTH & NEVILLE MANUFACTURING COMPANY in which the petitioner owned 4,400 shares, which petitioner acquired at a cost of $440,000.00, and which, as admitted, had a fair market value on the basic date of Marh 1, 1919, of $225,967.28.

The petitioner claims the right to deduct as a loss for the year 1919 its loss on its investment in

the 4,400 shares of stock in the WALWORTH & NEVILLE MANUFACTURING COMPANY under the provisions of paragraph (4), of Subdivision (a) of Section 234 of the Revenue Act of 1918, which provides that in computing the net income of a corporation, there shall be allowed,

> "Losses sustained during the taxable year and not compensated for by insurance or otherwise."

The instant case is analogous to the case of *Behlow Estate Co. vs. Commissioner of Internal Revenue,* decided by the United States Board of Tax Appeals on July 16th, 1928, and reported in *12 B. T. A. 1365* and upon which case the petitioner strenuously relies. In that case it appeared that H. F. Behlow offered to sell his 1,015.7 shares of the capital stock of the Behlow Estate Company for the cancellation of all indebtedness due by him to the corporation and the payment of $60,000.00, which amount was subsequently changed to $63,-500.00. The corporation did not have sufficient assets on hand and an arrangement was made whereby Behlow's offer was accepted by the corporation and the corporation agreed to pay him for his shares of stock, certain stocks and bonds in other corporations that it had acquired at a total cost of $42,100.50. There was also paid to him the sum of $10,000.00 in cash and he was given a promissory note of the corporation for the balance due. In the adjustment that was made by the corporation with Behlow, the stocks

and bonds that had been acquired at a total cost of $42,100.50 were turned over to Behlow at an agreed value of $32,211.00. The difference of $9,889.50, being the difference between the cost of the stocks and bonds to the corporation and the valuation placed thereon at the time they were turned over to Behlow, was claimed by the corporation as a loss resulting from the sale. The Commissioner of Internal Revenue disallowed the loss on the theory that this was a purchase by the corporation of its own shares of stock and so was a "capital transaction," from which neither gain nor loss could result. The Board, however, overruled the Commissioner and held in favor of the corporation, allowing the corporation to deduct the loss claimed. The Board, in a very clear decision, stated:

> "A stockholder of petitioner was desirous of selling his capital stock and petitioner, after consideration, decided to purchase the same upon the terms and conditions set forth in the findings of fact. The petitioner was to cancel the indebtedness of the seller, transfer to him certain stocks and bonds owned by it, pay $10,000.00 in cash, and give a promissory note for the balance due. The stock and bonds that figured in the transaction had been purchased by petitioner subsequent to March 1, 1913, at a cost of $42,100.50, and were sold to H. F. Behlow for a consideration of $32,211.00. The difference of $9,889.50 the petitioner seeks to deduct as a loss, resulting from the sale.
>
> "Counsel for respondent contends that this case is governed by the proposition that a cor-

poration can realize neither gain nor loss in the purchase of its own capital stock and relies in support thereof on the decision in the appeals of *Simmons & Hammond Manufacturing Co.,* 1 B. T. A. 803; *Farmers & Merchants State Bank,* 2 B. T. A. 130; *Farmers Deposit National Bank,* 5 B. T. A. 520; *H. S. Crocker Co.,* 5 B. T. A. 537; and A. R. R. 693, Cumulative Bulletin No. 5, p. 207.

"The cases relied upon are not authority for the position taken. This is not a case of a gain or loss realized or sustained by a corporation in the purchase of its own capital stock or gain or loss resulting from the purchase by or within an affiliated group of corporations. Petitioner seeks to take a loss represented by the difference between the cost of the stocks and bonds in question and the sale price thereof. The stock of petitioner is not in question nor a gain or loss resulting from the purchase thereof. In the appeal of *Simmons & Hammond Manufacturing Co., supra,* the petitioner had purchased its own capital stock and endeavored to take a loss on the subsequent sale of the same. We held that to be a capital transaction that did not result in a realized loss. Here the petitioner is not seeking such a loss but rather one that resulted from the sale to Behlow of stocks and bonds of other corporations for less than cost. The fact that the stocks and bonds were to be applied to the extent of their then value in payment of the purchase price of its own stock, does not make the same a capital transaction from which neither gain nor loss may result. *Cf. Callanan Road Improvement Co.,* 12 B. T. A. 1109.

"The good faith of the transaction is not involved, nor do we have the question of a

transaction having to do with a partial or complete liquidation or dissolution. What we would do if such questions were involved need not be here decided.

"Petitioner is entitled to the loss as claimed."

An interesting case on this same general proposition is that of *Callanan Road Improvement Company vs. Commissioner of Internal Revenue,* decided by the United States Board of Tax Appeals on July 3, 1928, and reported in *12 B. T. A. 1109.* In that case a dividend of $12,000.00 was declared by the petitioner corporation. The corporation owned in its own right, Liberty Bonds of the par value of $12,000.00. The Liberty Bonds were appraised at their market value and were delivered to the stockholders at the appraised market value in part payment of the cash dividend declared, and the remainder of the cash dividend was paid by cash from the treasury of the corporation. The bonds were originally purchased by the corporation for the sum of $12,000.00 and had a fair market value at date of payment to the stockholders of $10,636.80. The corporation deducted the difference of $1,363.20 as a loss for the year. The Commissioner disallowed the deduction. In holding the Commissioner to be in error and giving the taxpayer the right to deduct the loss claimed, the Board said:

"Does a corporation sustain a loss upon the payment of a dividend in property which

cost it more than the value at the time of payment to the stockholders? If the corporation had sold the bonds in question at the market price on February 14, 1921, there would be no question as to the deductibility of the loss. Instead of selling the bonds, however, it discharged an obligation of $10,636.80 with bonds of that market value. That there was a legal obligation as soon as the dividend was declared out of surplus see paragraph 3653, *Fletcher Cyclopedia of Corporations* and cases cited; also *W. E. Caldwell & Co., Inc.,* 6 B. T. A. 47. The situation is not governed by the principles involved in those cases in which we have decided, as in *Independent Brewing Co. of Pittsburgh,* 4 B. T. A. 870, that a corporation does not realize taxable income or a loss from the purchase or sale of its own bonds. Here we have a realization of the loss through complete disposition of certain assets of the corporation. The position of the stockholders as to whose stock dividend is voted is no different from that of general creditors. When the dividend of $12,000.00 was declared, the corporation could not satisfy the legal demands of the stockholders by the delivery to them of $10,636.80 worth of Liberty Bonds. The corporation thus parted with assets which cost it $12,000.00 and discharged its obligation for $10,636.80. We do not believe that *Bowers vs. Kerbaugh-Empire Co.,* 271 U. S. 170, announces a rule of law that is inconsistent with our holding, as we do, that a loss was sustained. That decision holds that no income resulted on discharge of indebtedness in a case where the entire transaction resulted in a loss. In this proceeding the loss was no less real because the disposition was made to stockholders."

The Board found and it was admitted by both parties that the unissued 756 shares of stock of the petitioner corporation in the taxable year in question had a fair market value of $107,197.53. These 756 unissued shares could just as well have been issued to the WALWORTH & NEVILLE MANUFACTURING COMPANY and by said company sold for said sum of $107,197.53, and the said amount distributed to the WALVILLE LUMBER COMPANY as its proportion of the liquidating dividend in the Manufacturing Company. In such case it could not be denied that the petitioner would have sustained a deductible loss measured by the difference between the sum of $225,967.28 being the March 1, 1913, value of petitioner's 4,400 share investment in the WALWORTH & NEVILLE MANUFACTURING COMPANY and the sum realized on liquidation, to-wit: $107,197.53, or a deductible loss of $118,769.75. What difference does it make if instead of selling the stock, it was distributed in specie to the WALVILLE LUMBER COMPANY as a liquidating dividend. This, of itself, does not turn the transaction into one where the corporation purchases or sells its own stock so as to come within the "capital transaction" rule adopted by the Treasury Department.

In this connection we would specifically call the Court's attention to the case of *New Jersey Porcelain Company vs. Commissioner of Internal Reve-*

nue, decided March 25, 1929, and reported in 15 B. T. A. 1059. The question in that case was whether the petitioner corporation sustained a deductible loss on the sale of certain assets. It appeared that the corporation had an authorized capital stock of $125,000.00 consisting of 1,000 shares of common and 250 shares of preferred stock; each of the par value of $100.00. One Wenczel was the owner of certain lands and buildings that he had acquired at a cost of $14,000.00. He turned said land and buildings over to the corporation for which the corporation paid by issuing its shares of stock of the par value of $14,000.00. Thereafter, the corporation constructed additional buildings and acquired additional property so that in the year involved, the depreciated cost of all of said property was $47,-088.35. The corporation then decided to abandon said property and offered the same for sale. Four stockholders of the said corporation decided to purchase the property and a sale of the property was made to the said four stockholders at an agreed price of $25,000.00, payable as follows: $1,340.00 in cash; $13,660.00 in common and preferred stock of the corporation, which was all of the stock owned by the said four stockholders, and $10,000.00 secured by a mortgage bond on the property. The $13,660.00 of the corporation's stock received by the corporation as a part of the consideration of the sale, were taken into the corporation's account as treasury stock. It was proven that the market value of the

corporation's common and preferred stock at all times was One Hundred ($100.00) Dollars per share. In its income tax return for the year in question, the corporation deducted the sum of $22,088.35 from its gross income as a loss sustained in such year from the sale of the said assets, said figure being the difference between the depreciated cost of the property sold and the amount of the purchase price paid by the said four stockholders. Upon audit, the Commissioner of Internal Revenue disallowed the said deduction and as reason therefor stated:

> "The transaction involving the sale of the old plant for shares of your capital stock is held to be a capital transaction within the meaning of Article 543 regulation 62, whereby no gain or loss can be recognized for income tax purposes."

The Board, however, held that this did not constitute a capital transaction within the meaning of the regulations and allowed the deduction. The Board said:

> "The Commissioner disallowed the loss in controversy on the theory that the inclusion of certain shares of the petitioner's outstanding capital stock in the consideration received from the purchasers converted the entire procedure of sale and purchase into a capital transaction from which neither gain nor loss could result. We think this contention is conclusively dealt with adversely to the theory of the respondent in *Behlow Estate,* 12 B. T. A. 1365. The facts in that appeal are quite similar to those proved

in the instant proceeding. The respondent there relied on our decisions in *Simmons & Hammond Manufacturing Co.,* 1 B. T. A. 803; *Farmers & Merchants State Bank,* 2 B. T. A. 130; *Farmers Deposit National Bank,* 5 B. T. A.; and *H. S. Crocker Co.,* 5 B. T. A. 537. In the *Behlow* decision we said:

"The cases relied upon are not authority for the position taken. This is not a case of a gain or loss realized or sustained by a corporation in the purchase of its own capital stock or gain or loss resulting from the purchase by or within an affiliated group of corporations. Petitioner seeks to take a loss represented by the difference between the cost of the stocks and bonds in question and the sale price thereof. The stock of petitioner is not in question nor a gain or loss resulting from the purchase thereof. In the appeal of *Simmons & Hammond Manufacturing Co., supra,* the petitioner had purchased its own capital stock and endeavored to take a loss on the subsequent sale of the same. We held that to be a capital transaction that did not result in a realized loss. Here the petitioner is not seeking such a loss but rather one that resulted from the sale to Behlow of stocks and bonds of other corporations for less than cost. The fact that the stocks and bonds were to be applied to the extent of their then value in payment of the purchase price of its own stock does not make the same a capital transaction from which neither gain nor loss may result. *Cf. Callanan Road Improvement Co.,* 12 B. T. A. 1109.

"In the case of *United States vs. Cedarburg Milk Co.,* 288 Fed. 996, the controversy hinged on facts almost identical to those herein, with the position of the parties reversed. There

the taxpayers sought to escape payment on the gain resulting from the sale of capital assets in which a part of the consideration was shares of its own capital stock. The Government opposed this contention. The court held for the Government. The substance of that decision is thus stated in the *syllabus:*

" 'Where facts showed that corporation, on a sale or other disposition of the property, made a gain, the taxability of such gain was not to be avoided on the theory that its property became merged with the property of another corporation, and it was immaterial that part of the consideration was in corporate stock of the vendee, and that under state law no right existed to stipulate for part of the consideration in corporate stock.'

"In conformity with our own decision in the *Behlow* proceeding, *supra,* and with the opinion of the court in *United States vs. Cedarburg Milk Co., supra,* we conclude that the transaction here involved is not to be regarded as the purchase by the petitioner of its own stock or the liquidation of such stock, but as a sale of capital assets. This being true, the purchase price must be ascertained by including therein the fair market value of the property other than cash and mortgages which was received. As we have found that the fair market price of petitioner's stock at date of sale was $100 per share, it follows that the alleged loss has been proved unless other facts of record yet to be considered bar this conclusion."

CONCLUSION

The evidence shows by overwhelming weight:

First, that the 4,400 share investment of the WALVILLE LUMBER COMPANY in the common stock of the WALWORTH & NEVILLE MANUFACTURING COMPANY was acquired in the year 1908 at a cost of $440,000.00 and had an admitted fair market value at the basic date of March 1, 1913, of $225,967.28.

Second, that the WALWORTH & NEVILLE MANUFACTURING COMPANY was dissolved in the year 1919 and that the WALVILLE LUMBER COMPANY received as its proportion of the liquidating dividend 756 unissued shares of its own common stock and received no more.

Third, that the 756 unissued shares of its own common stock which the WALVILLE LUMBER COMPANY received on liquidation of the WALWORTH & NEVILLE MANUFACTURING COMPANY had an admitted fair market value of $107,197.53.

Fourth, that the said 756 unissued shares of its own common stock received by the WALVILLE LUMBER COMPANY was the full amount which the said company was entitled to receive on account of its 4,400 share investment in the common stock of the WALWORTH & NEVILLE MANUFACTURING COMPANY.

Fifth, that the WALVILLE LUMBER COMPANY sustained a deductible loss in the year 1919, of $118,769.75 on its 4,400 share investment in the common stock of the WALWORTH & NEVILLE MANUFACTURING COMPANY, which amount is the difference between the fair market value thereof on the basic date of March 1, 1913, in the sum of $225,967.28, and the amount of $107,197.53, being the value of the 756 unissued shares of common stock in the WALVILLE LUMBER COMPANY received on liquidation of the Manufacturing Company in 1919.

It is submitted that the conclusion is irresistible that the Order of Redetermination of the United States Board of Tax Appeals entered on May 31, 1928, should be reversed and the cause remanded to said Board with instructions to allow the WALVILLE LUMBER COMPANY a deductible loss of $118,769.75 in its income and profits tax return for the year 1919.

Respectfully submitted,

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